Recent Patterns of Corporate External Financing

In the period of expansion since 1970, nonfinancial corporations have engaged in external financing at a rate that, by historical standards, is large both in dollar volume and relative to corporate product. Until the final quarter of 1972, the mix of financial instruments used to raise these funds had been somewhat different from the financing practices of earlier years, because it involved much heavier reliance on long-term debt and equity markets than had been common over the 1960's as a whole.

Since the final quarter of 1972, the dollar volume of corporate external financing has continued to be exceptionally large in relation to the level of economic activity. However, the pattern of external financing now has returned to one more like that before 1971. The portion raised in long-term debt and equity markets has fallen to about the 1969 level—or somewhat below the average of the 1960's. This shift of emphasis back to short-term markets has reflected mainly the general rise in interest rates since late 1972.

Despite this change, the severe stringencies in the 1969 financial environment have not been present recently—or at least not to the same degree. The relatively more relaxed conditions in 1973 are attributable mainly to changes in financial regulations and to the financing patterns that emerged during the intervening years. The suspension of Regulation Q ceilings on large certificates of deposit (CD's) in mid-May 1973 has permitted banks to bid for funds more competitively than in past periods of monetary restraint. Therefore, bank credit in general has continued to be available in 1973, although at increasingly high interest and other costs. In addition, it appears that corporate holdings of liquid assets are much more consistent with the volume of internal funds being generated than they were in 1969. Finally, the balance sheet restructuring that occurred in 1971 and 1972 has provided corporations with somewhat greater financial flexibility than before.

THE COMPOSITION OF EXTERNAL FINANCING

Changes in the volume and composition of corporate external financing for the period since 1968 are documented in Table 1. As was the case in 1969, many recent financing decisions seem to have been explained by interest rate expectations and the yield spreads between highly substitutable instruments. Over the period as a whole, however, two more persistent factors appear to have exerted major influences on the structure of financing undertaken.

First, corporations entered the present expansionary period with liquidity positions considerably eroded, following the substantial volume of short-term financing in 1969 and early 1970. The desire to restore these positions meant that a larger-than-normal share of total funds raised in 1971 was used to fund short-term debt and to build liquid asset balances. In fact, even in the recent period of rising interest rates, these asset balances have been augmented further. Second, internal funds generally have grown less rapidly of late in relation both to gross product and to capital outlays.

TABLE 1

NONFINANCIAL CORPORATIONS: STRUCTURE OF DEBT AND EXTERNAL FINANCING

Amounts shown in billions of dollars

Period	Total		Equity		Bonds		Mortgages		Bank loans		Other credit market instruments		Other liabilities	
	Amount	Per cent	Amount	Per cent	Amount	Per cent	Amount	Per cent	Amount	Per cent	Amount	Per cent	Amount	Per cent
	Outstanding, end of period													
1969..	518.6	100.0	n.a.	n.a.	147.6	28.4	71.8	13.9	97.0	18.7	23.1	4.4	179.2	34.6
1970..	555.5	100.0	n.a.	n.a.	167.3	30.1	77.0	13.9	102.6	18.5	26.3	4.7	182.2	32.8
1971..	596.4	100.0	n.a.	n.a.	186.1	31.2	88.5	14.8	107.4	18.0	26.3	4.4	188.1	31.5
1972..	655.2	100.0	n.a.	n.a.	198.3	30.3	104.1	15.9	120.9	18.5	28.8	4.4	203.0	31.0
	Funds raised during period													
1969..	54.8	100.0	2.9	5.3	12.0	21.9	4.6	8.4	11.6	21.2	7.1	13.0	16.5	30.1
1970..	41.3	100.0	4.8	11.6	19.8	47.9	5.2	12.6	5.7	13.8	3.3	8.0	2.5	6.1
1971..	52.8	100.0	11.7	22.5	18.8	35.6	11.4	21.6	4.8	9.1	0.6	1.1	5.5	10.4
1972..	68.9	100.0	10.4	15.1	12.2	17.7	15.6	22.6	13.9	20.2	2.5	3.6	14.4	20.9
1972—														
Q1..	56.6	100.0	8.5	15.0	12.4	21.9	13.0	23.0	7.6	13.3	1.3	2.3	13.8	24.4
2..	59.0	100.0	12.8	21.7	12.9	21.9	15.0	25.4	7.2	12.2	4.6	7.8	6.4	10.9
3..	66.7	100.0	10.2	15.3	12.4	18.6	16.8	25.2	11.8	17.8	1.6	2.4	13.9	20.8
4..	93.3	100.0	10.0	10.7	11.1	11.9	17.7	19.0	28.7	30.8	2.4	2.6	23.4	25.1
1973—														
Q1..	92.3	100.0	9.6	10.4	7.8	8.5	15.0	16.3	54.8	59.4	−10.1	−10.9	15.0	16.3
2..	103.6	100.0	8.8	8.5	11.0	10.6	19.5	18.8	27.0	26.1	2.3	2.2	34.9	33.7
3..	105.7	100.0	3.1	2.9	7.9	7.5	21.7	20.5	28.2	26.7	3.2	3.0	41.6	39.4

n.a.—Not available.
NOTE.—Data from flow of funds accounts are quarterly at seasonally adjusted annual rates; 1973 Q3 preliminary. Other credit market borrowing consists of commercial paper and loans from finance companies and the U.S. Government. Other liabilities are trade credit, profits tax liabilities, and miscellaneous.

This more sluggish growth undoubtedly has reinforced the desire of nonfinancial corporations to rebuild liquidity, in addition to requiring more external financing for the investment that has occurred.

While the volume of external financing that took place between 1970 and the end of 1972 was dictated by the general shortage of internal funds relative to investment and liquidity objectives, its composition was influenced by two further considerations. One was the desire to fund some short-term debt as a means of improving debt capacity in both short- and long-term markets. The other was the desire to accomplish this restructuring in a manner that would slow the rate of increase in debt/equity ratios. To implement these objectives—once interest rates had retreated from their peaks in 1970 and the stock market had recovered from its mid-1970 lows—nonfinancial corporations expanded their reliance on long-term financing, particularly in market sectors where they had previously been inactive.

The particular instruments involved in this expanded reliance on long-term borrowing tended to change somewhat as the period progressed. Net bond issues, at a record $19 billion in 1971, dropped back in early 1972 to about a $12.5 billion annual rate—about the same as in most other years since 1967, even though the total amount of debt financing was far more modest in those earlier years. Also, in 1971 an increasing amount of corporate long-term debt funds began to be provided through mortgages, with the growth concentrated more in mortgages secured by commercial properties than in those secured by residential investment. Growth in this area was encouraged by the greatly expanded flows of savings into banks and thrift institutions at a time when some of the funds previously available from the insurance sector for direct corporate debt financing were being absorbed by other investments, particularly those in the equity market. Furthermore, the higher interest cost of mortgage funds relative to privately placed debt was to some extent offset by the ability of physical collateral to substitute for debt covenants and other restrictions on financial policy that traditional lenders might have imposed on firms at that time.

Net new issues of equity had been small during the late 1950's and 1960's; in fact, in 1968 at the peak of the conglomerate merger movement, nearly $1.5 billion of equities in nonfinancial corporations had been retired, much of it through exchange into convertible debt. During the early 1970's, on the other hand, the pattern of stock financing changed rather dramatically. More stock was issued (net) between 1969 and 1972 than had been issued cumulatively in the public market during the preceding decade and a half—with most of the expansion occurring after 1970. Much of the increase was accounted for by the shares of utility companies, since many such firms had exhausted their capacity to issue additional debt, but issues of manufacturing companies also grew substantially.

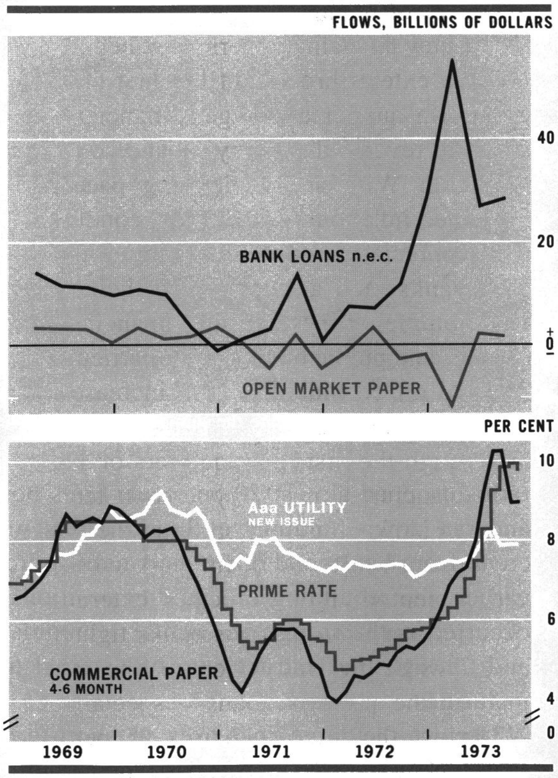
The new financing patterns that began to emerge in 1971 persisted to some extent throughout the first three quarters of 1972, but by the fourth quarter a changed financial and economic environment began to reverse the heavy reliance on capital markets for external financing. With an accelerating pace of economic activity and continued inflationary pressures, conditions in credit markets tightened appreciably; corporations more than doubled their borrowing from banks, and also increased their other short-term borrowing. The volume of new equity financing receded after the second quarter, and public bond issues, particularly those of manufacturers, dropped off considerably. An increase in mortgage financing was the only departure from a general shift to short-term financing.

Through the first three quarters of 1973 businesses concentrated their financing increasingly in short-term maturities. A first-quarter surge in bank loans was partly at the expense of commercial paper and other short-term credit market borrowing, and accounted for 60 per cent of total corporate external financing. The flow was reduced later in the year as banks tightened nonprice terms of their loans, while the institution of the two-tier prime rate in April allowed the price of loans—especially to large corporations—to rise. Nevertheless, more than 25 per cent of external corporate financing was still being provided by banks in the third quarter, a share that is large by historical standards. Rising interest rates and inflation have also led to substantial increases in other short-term business liabilities. In periods of rising prices and profits, tax liabilities tend to accrue faster than payments are made, and trade credit becomes an increasingly important source of funds in periods of general credit stringency, especially for small business.

Despite the fact that utility firms continued to raise funds through issues of preferred stock, the flow of business financing through equity markets declined throughout most of the year to a level that, in the third quarter, was only one-third as large as the year before. The depressed level of stock prices throughout much of the year has made equity financing more costly.

Business needs for long-term credit have continued to be covered to an important extent in the mortgage market and, to a lesser extent, in bond markets. Through the third quarter of 1973 the volume of new bond offerings dropped off to a significant degree, particularly in public markets; in fact, for the third quarter the volume of gross new public offerings was the smallest since the final quarter of 1966. During most of the year, market expectations that interest rates were likely to fall once the business expansion

1 | Borrowers substitute SHORT-TERM BANK CREDIT for commercial paper in early 1973



Flow of funds accounts data. n.e.c. Not elsewhere classified.

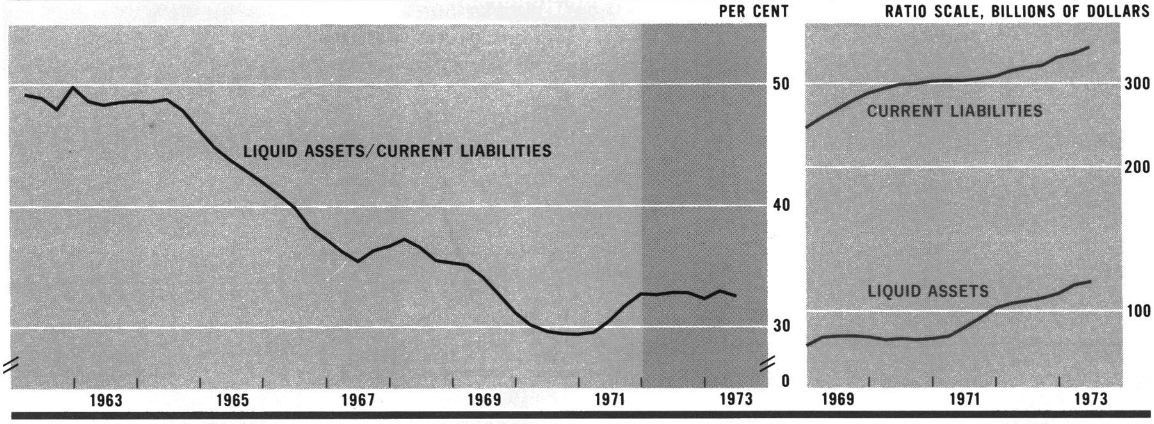
slowed have limited borrower demands on the bond market. These expectations have tended to restrain advances in bond yields relative to those on short-term instruments.

The over-all volume of corporate financing has remained strikingly large this year despite the increased cost of borrowing and the shift of emphasis back toward short-term debt. There has been a growing deficiency of internal funds relative to capital outlays, but in addition corporations in the past year have used the availability of short-term funds to add to their stock of liquid assets. This situation is in marked contrast to previous periods of high interest rates and monetary restraint when the drawing down of liquid asset balances substituted for the funds that could no longer be raised in credit markets.

LIQUIDITY

Before 1971, holdings of liquid assets had been declining relative to current liabilities for many years, as rising interest rates and better techniques of cash management encouraged corporations to economize on liquid asset balances. The rate of decline had accelerated in the late 1960's, but in 1969 and early 1970 liquidity

2 | CORPORATE LIQUIDITY RATIO continued its long postwar decline until 1971



SEC end-of-quarter data, seasonally adjusted by F.R. Liquid assets are the sum of cash, U.S. Government securities, and "other" current assets.

ratios dropped almost 20 per cent; firms both borrowed short-term and ran down holdings of liquid assets when the availability of credit from banks and other short-term sources decreased. As noted earlier, the rebuilding of liquidity positions in late 1970 and 1971 occurred both through the actual accumulation of liquid balances and through the restructuring of external financing toward longer maturities.

Despite the large increases in short-term or current liabilities that have occurred this year, the liquidity ratio has remained remarkably stable, given its long history of decline. It is, therefore, quite likely that firms have raised the target level of liquid asset holdings that they desire to maintain. Reasons for this are not hard to find. Corporations may simply wish to avoid a repetition of the liquidity crisis of 1970. But several new uncertainties not present in 1970 apparently have also been added.

Inasmuch as foreign currency balances are a necessity to firms doing a substantial international business, the fact that many

TABLE 2

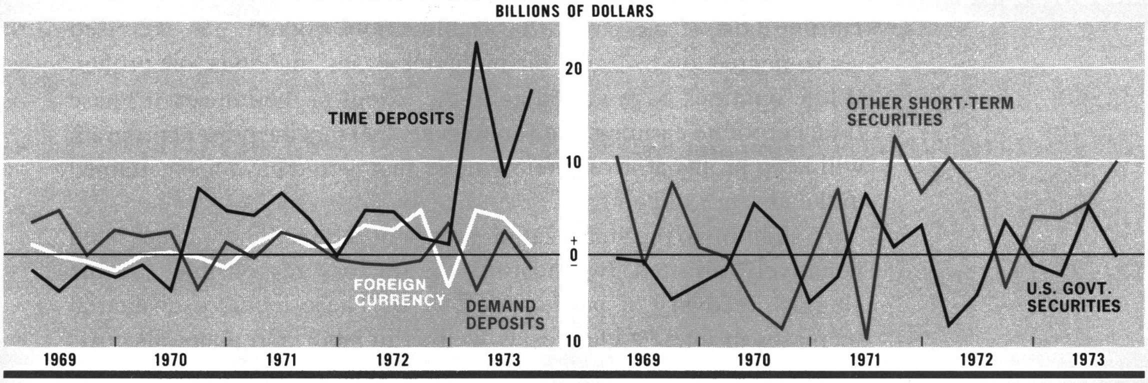
COMPOSITION OF LIQUID ASSETS OUTSTANDING

End of year, not seasonally adjusted

Type of asset	In billions of dollars				In per cent			
	1969	1970	1971	1972	1969	1970	1971	1972
Domestic liquid assets plus foreign currency	80.2	78.8	90.7	97.6	100.0	100.0	100.0	100.0
Foreign currency	1.3	.9	2.3	4.1	1.6	1.2	2.6	4.2
Liquid assets	78.9	77.8	88.4	93.5	98.4	98.8	97.4	95.8
Demand deposits and currency	34.9	35.2	35.9	36.0	43.4	44.8	39.6	36.9
Time deposits	11.8	13.5	17.1	20.2	14.7	17.1	18.8	20.7
U.S. Govt. securities	7.0	7.3	9.4	7.0	8.7	9.3	10.3	7.1
Other short-term assets	25.3	21.8	26.0	30.3	31.5	27.6	28.7	31.1

SOURCE.—Board of Governors of the Federal Reserve System, *Flow of Funds Accounts, 1945–1972.*

3 | LIQUID ASSETS flow primarily into interest-bearing instruments



Flow of funds accounts data. 1973 Q3 preliminary. Other short-term assets consist of commercial paper, security RP's, and State and local securities.

exchange rates have been floating since the general currency realignments of late 1971 has undoubtedly created a liquidity demand for such balances over and above the bookkeeping effects of the dollar devaluation on dollar values of foreign-denominated balances.

Furthermore, the accelerating rate of inflation, especially in prices of raw materials, uncertainties about the future course of the wage–price stabilization program and its impact on profits; and actual shortages and delivery delays in the case of many supplies have also increased the difficulty of predicting cash flow with any degree of accuracy. In addition, the level of profits and cash flow has been smaller relative to corporate product than was true earlier in the decade. For these reasons and apart from international considerations firms may wish to have a larger liquidity cushion.

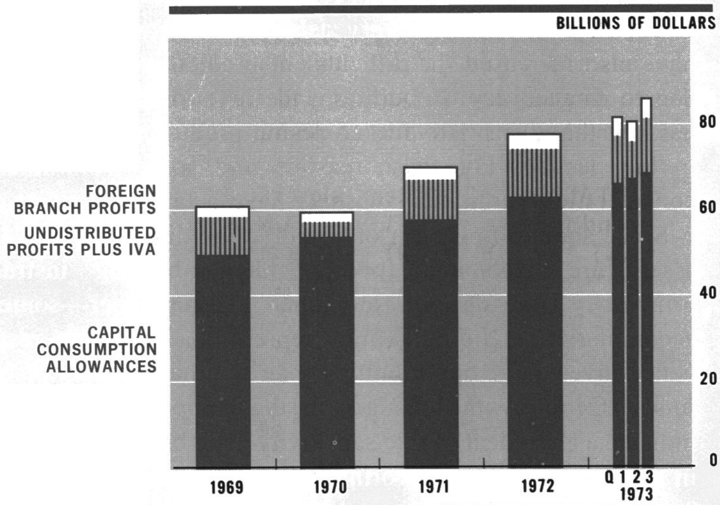
Since about 60 per cent of corporate holdings of domestic liquid assets are accounted for by interest-bearing instruments—principally time deposits and open market paper—some of this accumulation of liquidity may represent a corporate response to better investment opportunities than alternative uses of corporate funds. Certainly the changes in the composition of these flows indicate a great deal of rate sensitivity. The build-up of CD balances in the past year is noteworthy, and many corporations apparently borrowed from banks in order to acquire CD's early in 1973 when the prime rate was well below other short-term rates. There is also a high degree of substitutability between U.S. Government securities and other short-term market instruments. Whatever the causes of this development, the volume of liquid assets that nonfinancial corporations have acquired in the past year has been substantial—a marked departure from the behavior typical of past periods of rising interest rates and restrictive monetary policy.

CAPITAL OUTLAYS AND INTERNAL FUNDS

Besides being less predictable, corporate internal funds have not grown so rapidly as corporate income since the 1969–70 recession. During most of the period the stabilization program has exercised some degree of restraint on price increases and thus on profits. While opinions have varied as to the extent of the impact of Phase II on corporate earnings, most observers feel that the present program will keep profits at levels below those that would have been attained in the absence of controls.

In addition to the stabilization program, retained income has been negatively affected by most of the factors responsible for the sluggish recovery of profits since 1970. These include substantial increases in interest charges as well as in labor and materials costs that firms could not completely pass on. Furthermore, an increasing share of reported gains in book profits has reflected inventory profits resulting from inflation rather than a sustainable level of operating earnings. The inflation factor has been particularly troublesome in 1973 when the size and volatility of the adjustment for inventory profits have made quarterly movements in earnings unusually difficult to interpret.

4 **CAPITAL CONSUMPTION ALLOWANCES continue to supply major part of internal funds**



Flow of funds accounts data. 1973 Q3 preliminary. IVA Inventory valuation adjustment.

Adding to internal funds, however, have been the depreciation liberalization of the Asset Depreciation Range System and the investment tax credit, both introduced in 1971, as well as the substantial tax write-offs of 1970. The dividend restraint program of the Committee on Interest and Dividends, especially before its liberalization in June 1973, undoubtedly increased the rate of

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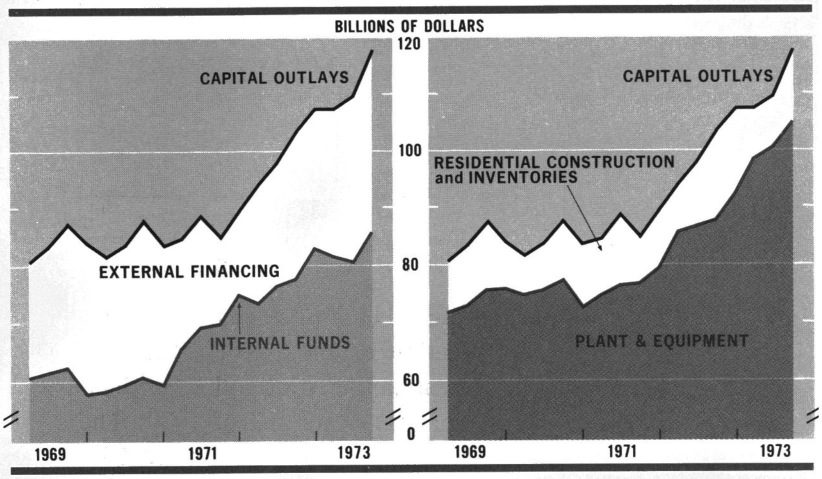
retention of after-tax profits. Earnings repatriated from foreign branches have also augmented the funds available to U.S. corporations with international operations. Since such earnings have been growing more rapidly than those from domestic operations, they have become an increasingly important source of funds.

After rising in 1971 by only 3 per cent above their level in 1970, corporate capital outlays rose by 16 per cent in 1972; increases in the first three quarters of 1973 averaged more than 12 per cent, annual rate, even with a zero rate of growth in the first quarter. Although until recently residential construction has been the fastest growing component of corporate capital spending, plant and equipment expenditures have always accounted for the bulk of these outlays.

Growth in business fixed investment was largely concentrated in the communications and utility sectors until manufacturing outlays also began to increase to a significant degree late in 1972. Inventory accumulation has been relatively modest, and inventory/sales ratios have declined to unusually low levels. Firms have reduced the number of product lines and attempted to turn stock more often, and shortages and the underestimation of sales may also have kept inventory levels low.

In short, for the period as a whole, internal funds have not been so large, relative to capital outlays, as they were before the 1969–70 recession, and the gap has increased further in 1973. This development has added to corporate demands on credit markets for funds both to finance capital outlays and to fund the higher levels of liquidity that firms now feel it desirable to maintain.

5 | CAPITAL OUTLAYS, after a slow recovery, expand faster than INTERNAL FUNDS. . . PLANT AND EQUIPMENT outlays are especially strong



Flow of funds accounts data. 1973 Q3 preliminary.

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Recently, rates of capacity utilization have been high in many basic manufacturing industries, and the number of manufacturers who believe that more capacity is needed has grown. According to recent survey data, manufacturing outlays for plant and equipment in 1973 are expected to be almost 20 per cent above 1972, although the outlook beyond 1973 has been clouded recently by the embargo on Middle Eastern oil. While the rate of growth in business profits has been decelerating, large increases in plant and equipment outlays still seem to be indicated for precisely those industries where shortages now exist.

In an effort to reduce inflationary pressures, monetary policy moved toward restraint after the final quarter of 1972. In previous periods of monetary restraint, as the spread between capital outlays and internal funds widened, funds available to corporations became increasingly tight, and holdings of liquid assets were reduced as short-term credit became less available. That this same pattern did not occur in the recent period is in large measure due to the continuing availability of bank credit; banks have used their freedom from Regulation Q rate ceilings on large CD's to bid aggressively for funds in this market.

However, corporate debt/equity ratios, debt structure, and liquidity levels now imply greater financial flexibility and consistency with the flows of internal funds likely to be realized. Hence, the restructuring of corporate balance sheets after 1970 contributed to an easier transition to the higher level of interest rates necessary to finance real expansion of plant and equipment in an inflationary environment. □